IP 06-0076-CR 1 H/F USA v Ellis
Judge David F. Hamilton Signed on 12/20/06

NOT INTENDED FOR PUBLICATION IN PRINT

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

USA,	)	
	)	
Plaintiff,	)	
vs.	)	
	)	
ELLIS, SUSAN B,	)	CAUSE NO. IP06-0076-CR-01-H/F
	)	
Defendant.	)	

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

UNITED STATES OF AMERICA,	)	
	)	
Plaintiff,	)	
	)	
v.	)	CASE NO. IP 06-76-CR-1 H/F
	)	
SUSAN B. ELLIS,	)	
	)	
Defendant.	)	

ENTRY ON PENDING MOTIONS

A grand jury indicted defendant Susan B. Ellis on eight counts of violating 26 U.S.C. § 7202 by failing to account for and pay over taxes withheld from employees' paychecks for eight consecutive quarters from 2001 to 2003. Trial is scheduled for February 12, 2007, and a number of motions are pending.

I. *Defense Motions in Limine*

Defendant Ellis has filed motions in *limine* to exclude evidence: (a) of her failure to file tax returns and to pay taxes for times before those covered by the indictment (Docket No. 30); (b) relating to her individual and corporate tax liabilities during the times covered by the indictment (Docket No. 22); (c) relating to the dollar amounts of the unpaid employment taxes that are the subject of the charges, and defendant's use of the money saved by not paying the taxes over to

the IRS (Docket No. 23); and (d) relating to unpaid employer portions of FICA taxes at the same time covered by the indictment (Docket No. 27).

A. *The Charges*

The indictment alleges violations of § 7202, which provides: "Any person required under this title to collect, account for, and pay over any tax imposed by this title who *willfully* fails to collect or truthfully account for and pay over such tax shall, in addition to other penalties provided by law, be guilty of a felony. . . ." (Emphasis added.) The defendant's pending motions focus on the evidence the government intends to offer to prove the element of willfulness. This focus is noteworthy in light of the defendant's earlier motion to continue the trial so that she could undergo a psychological evaluation relevant to willfulness.

The Supreme Court has interpreted the willfulness standard in criminal tax prosecutions to impose a heavy burden on the government:

> Willfulness, as construed by our prior decisions in criminal tax cases, requires the Government to prove that the law imposed a duty on the defendant, that the defendant knew of this duty, and that he voluntarily and intentionally violated that duty.

Cheek v. United States, 498 U.S. 192, 201 (1991) (holding that defendant was entitled to defend on theory that he had unreasonable but good faith belief that tax laws did not apply to him). This heavy burden of proof, however, opens the

door to various types of evidence that may show that the defendant was aware of the applicable law:

> Of course, in deciding whether to credit Cheek's good-faith belief claim, the jury would be free to consider any admissible evidence from any source showing that Cheek was aware of his duty to file a return and to treat wages as income, including evidence showing his awareness of the relevant provisions of the Code or regulations, of court decisions rejecting his interpretation of the tax law, of authoritative rulings of the Internal Revenue Service, or of any contents of the personal income tax return forms and accompanying instructions that made it plain that wages should be returned as income.

Id. at 202.

B. *The Government's Case*

To prove that defendant Ellis acted willfully in failing to account for and pay over employment taxes in 2001 to 2003, the government intends to offer evidence showing the following. The court's summary is not an endorsement but simply reflects the government's summary. Since 1995, Ellis has owned, operated and controlled Pharmasource, a temporary staffing service for pharmacists. The corporation is a Subchapter S corporation, so that its income is reported on Ellis's individual tax return. Since its founding, Pharmasource has always withheld employee income and FICA taxes and has provided W-2 forms to its employees every year. The company website advertises to prospective clients that it will handle the tax withholding and accompanying paperwork functions for its employees who are assigned to provide pharmacy services to clients.

From 1996 to 1999, accountants for Pharmasource prepared the 941 quarterly tax returns and gave the returns to Ellis with directions on when and where to file the returns. The accountants also calculated the amount of employee income tax withholding deposits that Pharmasource should have been making every two weeks and provided that information to Ellis.

In 1999, the accountants discovered that Ellis had not filed any 941 returns or paid over the employee income taxes since 1995. In 1999 and 2000, Ellis eventually filed the 941 returns for the years 1996 through 1999. She then paid belatedly only a portion of the taxes that had been withheld from employee paychecks during those years.

In 2000, Ellis hired a large payroll processing company, ADP, to do the payroll and employee tax withholding accounting, to make the tax payments, and to file the 941 returns. During that time, taxes were withheld and paid over to the IRS every two weeks, and the 941 tax returns were filed on a quarterly basis. Then, in January 2001, Ellis terminated the contract with ADP. She hired a company to install payroll software on Pharmasource's own computers so that Ellis could prepare the payroll and maintain control over the payment of federal employee tax deposits. She made some deposits in the first quarter of 2001, but made no more deposits for the rest of 2001, all of 2002, and the first quarter of 2003. She also filed no 941 returns in 2001, 2002, or for the first quarter of 2003.

Yet throughout that time, she continued to withhold income taxes and FICA taxes from her employees' paychecks and continued to provide W-2 forms.

Also according to the government, at about the time Ellis stopped making federal employee tax deposits in early 2001, she began transferring money instead from the Pharmasource business bank account to an "investment account," which she then used to build and furnish a personal residence at a cost of about $2.5 million.

A civil IRS tax collector began reviewing Ellis's personal tax situation in 2003. The tax collector discovered that Ellis owned Pharmasource and had earned substantial income from the company, but that she had not filed any personal income tax returns from 1995 through 2002. The tax collector also discovered that the company had not filed any Subchapter S corporate returns for the years 1995 through 2002. After the collector contacted Ellis about her personal tax situation in May 2003, Ellis began to make a portion of the Pharmasource employee tax deposits but still did not file the 941 returns.

The IRS investigation revealed that Ellis had been running Pharmasource profitably and had withheld employee income taxes but had not paid them over to the IRS and had not filed 941 returns for the eight quarters covered by the indictment. After the IRS officer discovered that Ellis had built a home in 2001

for approximately $1.2 million with no liens or mortgages on it,[1] and after Ellis told the officer that she was responsible for filing and paying the 941 taxes but had not done so, the case was referred for criminal prosecution. After Ellis's attorney was notified of the criminal tax investigation in 2004, Ellis filed corporate tax returns for the company for 1995 and 1996 but did not pay any individual income tax.

The government intends to offer evidence about the defendant's personal expenditures of approximately $3.3 million during the relevant time period, including a $140,000 home for her mother, her own custom-built home with extravagant furnishings and extras, large donations to her church, and a new automobile.

The government expects IRS personnel to testify that Ellis's failure to file individual and corporate returns for Pharmasource made the discovery of the charged violations of § 7202 more difficult because the IRS did not have records of Pharmasource as an ongoing business after 1995.

C. *The Challenges to the Evidence*

Ellis argues that the evidence she challenges would be unfairly prejudicial to her and is not necessary for the government's proof of the elements of the

[1]At this stage of the case, the court cannot explain the difference between the $2.5 million and $1.2 million figures for the new house.

offense. The government responds that all of this evidence is relevant to the issue of willfulness and/or to a possible defense that Ellis was not able to pay the taxes over to the IRS.

The evidence regarding the handling of Pharmasource's employee withholdings and tax returns from 1995 through 2001 appears likely to be highly probative of the defendant's state of mind, especially under the stringent standard requiring proof of willful violations. See *United States v. Simkanin*, 420 F.3d 397, 405-06 (5th Cir. 2005) (discussing complications presented for trial when defendant claims he did not understand legal obligations concerning withheld employee taxes). The evidence of the earlier failures to file the returns and to make deposits, even when accountants were doing all of the work except the final submissions, and of the events leading to (partial) corrections of those failings, followed by defendant's hiring of ADP and her decision to re-take control over those functions, is all relevant to show that defendant fully understood that Pharmasource was withholding the taxes and that the company and she were legally responsible for filing the returns and depositing the money with the IRS. The court does not treat this course of events as Rule 404(b) evidence, but as part of the evidence allowed under *Cheek* to show that Ellis was aware of her duty to file the returns and to pay over to the IRS the taxes withheld from employee paychecks.

At least some of the evidence regarding the defendant's failures to file individual and corporate tax returns and to pay taxes for several years is also likely to be probative of the defendant's state of mind on the charged violations. The court sees the government's evidence as tending to show that the charged criminal violations were part of a larger pattern of disregard for federal tax obligations that a jury could find was willful. In saying this, the court does not intend to allow the trial to get bogged down in a trial of the individual and corporate tax liabilities, but the basic facts of not filing any returns or paying any taxes for several years appear to be sufficiently probative of the defendant's state of mind toward her obligations toward employee withholding as to be admissible. Again, the court does not treat these facts as Rule 404(b) evidence, but as part of the evidence allowed under *Cheek* to show that Ellis was aware of her duties under the tax laws and her complete disregard of those duties. The same reasoning applies to the evidence from Revenue Agent E. Woodrow Smith that Ellis also failed to pay the employer portion of the FICA taxes. The court will give the jury instructions to make clear the proper focus of its deliberations and to avoid confusion or mis-use of the evidence.

The evidence of the amounts of money that Ellis failed to pay the government and of her personal expenditures is also probative of willfulness. Ellis points out correctly that the government is not required to prove the amount of taxes owed. That is not an element of the offenses charged under § 7202. It is a crime to fail to pay over to the government any money withheld from employees'

paychecks under the authority of tax law. The amounts in question are relevant to willfulness, however. For example, if the government decided to use its limited resources to charge a person with failing to pay trivial amounts of employee withholding taxes (or trivial amounts of individual income taxes), the law would allow the defense to argue that the amounts were so trivial as to have escaped the defendant's notice. Conversely in this case, the government should be entitled to show that the amounts involved were so large that the failures could not have been the result of negligence or innocent oversight. See *United States v. Daniels*, 387 F.3d 636, 641 (7th Cir. 2004) (in prosecution under § 7201, "evidence of a large or substantial tax deficiency may aid the government in proving willfulness," but is not itself an element of the offense). The government is not required to prove the amounts, but it may do so, at least to help prove willfulness.

The evidence of Ellis's management of the corporation's money and her personal expenditures during the relevant time period is relevant for a different reason. The government points out the Ninth Circuit holding in *United States v. Poll*, 521 F.2d 329, 332-33 (9th Cir. 1995), that the defendant under § 7202 was entitled to defend on the theory that his violations were not willful because he was unable to pay over the withheld taxes and he intended to make up the deficiencies later. The government suggests it is entitled to offer evidence to block such a theory of defense. In *United States v. Evangelista*, 122 F.3d 112, 119 (2d Cir. 1997), the Second Circuit affirmed the district court's refusal to give an instruction under *Poll*, but did so based on the evidence that showed the

defendants had been able to pay for mortgages on multiple personal residences, their children's weddings, tuition, and to lease a luxury auto. That reasoning in *Evangelista* certainly did not reject the reasoning of *Poll*, and under that reasoning, the defendant's personal expenditures are relevant to willfulness.[2]

The court does not expect the government to go through all of the expenditures in loving detail intended to inflame the jury. (If the government were to take that course, the court would impose limits, relying on Rule 403 of the Federal Rules of Evidence.) But the basics of the defendant's expenditures and at least some of the specifics are probative of willfulness here.

As to all of these issues, the court has also considered defendant's arguments under Rule 403 of the Federal Rules of Evidence. The government's theories of probative value are persuasive here, and the court believes that proper jury instructions should be sufficient protection against unfair prejudice. The court will impose limits as needed to avoid waste of time or confusion, but the court sees no basis for a blanket prohibition on any of these categories of evidence.

---

[2]Other circuits have disagreed on this point. See *United States v. Ausmus*, 774 F.2d 722, 724 (6th Cir. 1985) (rejecting defense of inability to pay in § 7203 prosecution for failure to pay income taxes); *United States v. Tucker*, 686 F.2d 230, 233 (5th Cir. 1982) (same). In *United States v. Dreske*, 536 F.2d 188, 195 (7th Cir. 1976), the Seventh Circuit held that a defense of inability to pay was not available in a prosecution under § 7215 for failure to deposit FICA taxes in separate bank account. As long as the issue is open to fair debate, the government is entitled to build a case that would withstand this available theory of defense.

If Rule 404(b) applied to any of the challenged evidence, the government has offered a persuasive case for admitting the evidence. The evidence is not admissible to show Ellis's character and action in conformity with that character, but it may be used to show her intent and knowledge, and the absence of mistake or accident. The Seventh Circuit has adopted a four-factor test to structure analysis under Rule 404(b). "The four factors are: (1) the evidence is directed towards a matter in issue; (2) the prior act is similar enough and close enough in time to the charged offense; (3) the jury can find from the evidence that the defendant committed the prior act; and (4) the danger of unfair prejudice does not substantially outweigh the probative value of the evidence." *United States v. Joseph*, 310 F.3d 975, 978 (7th Cir. 2002).

First, the court has explained above how the different categories of evidence are directed toward matters in issue, even though the government is not necessarily required to prove all the details such as amount or ability to pay taxes. Second, the prior acts concerning failure to file 941 returns and to pay over withheld taxes to the IRS from 1996 to 1999 are similar enough and close enough in time to the charged offenses to be highly probative on the key issues of knowledge and willfulness. The other categories of challenged evidence are all contemporaneous with the charged offenses and are part of the relevant course of conduct for purposes of evaluating willfulness. Third, the court assumes for now that the government will be able to offer strong evidence on these matters. Fourth, the court is satisfied that the danger of unfair prejudice does not

substantially outweigh the probative value of the evidence. The court will use jury instructions, including cautions during the trial, to keep the jury focused on the proper use of such evidence, and will take steps to avoid undue confusion and waste of time.

Accordingly, the court denies defendant's motions in *limine* to exclude evidence of her failure to file tax returns and to pay taxes for times before those covered by the indictment (Docket No. 30); relating to her individual and corporate tax liabilities, including the times covered by the indictment; (c) relating to the dollar amounts of the unpaid employment taxes and defendant's use of the money (Docket No. 23); and (d) relating to the unpaid employer portion of the FICA taxes.

II. *Defendant's Motion to Strike*

Defendant also moves to strike the portions of the indictment alleging that she spent the trust fund money on personal expenses, including personal residences, home decorating, and an auto, and the allegations specifying the amounts of the unpaid taxes. She argues that these matters are not elements of the offense under § 7202 and that they are extraneous and prejudicial. The motion to strike under Rule 7(d) of the Federal Rules of Criminal Procedure is directed to the court's discretion. See *United States v. Marshall*, 985 F.2d 901, 905-06 (7th Cir. 1993). A federal indictment need not always be limited to a recitation of the elements of the offense. (In fact, more often, the court sees

motions from defendants that seek more details than are included in the indictment.) For the reasons explained above concerning the evidence on the personal expenditures and the amounts of the unpaid taxes, the court does not see a need to strike these factual allegations. Defendant's motion to strike (Docket No. 21) is denied.

III. *Other Motions*

The defendant has also moved (Docket No. 24) for an order requiring the government to disclose any evidence it intends to offer under Federal Rule of Evidence 404(b). The government has responded with its summary of the evidence it intends to offer, but has argued that evidence is admissible as part of its principal case and without resort to Rule 404(b). Even if Rule 404(b) applied to the evidence of earlier failures to file returns and pay over withheld taxes, the evidence of defendant's failures to pay and file returns on personal and corporate taxes, the evidence of the defendant's personal expenditures and the amounts of the unpaid withheld taxes, and/or the evidence that she also failed to pay the employer portion of the FICA taxes, the court finds that the government's response has been sufficient to give the defendant fair notice of the evidence it intends to offer.

Defendant also moved for disclosure of expert testimony from the government (Docket No. 19). That motion is denied as moot, as the government

has provided such notice. The government has moved (Docket No. 17) for reciprocal discovery under Rule 16(b)(1) of the Federal Rules of Criminal Procedure. That motion is granted, and defendant must disclose no later than 31 days before trial any expert testimony she intends to offer.

So ordered.

Date: December 20, 2006

DAVID F. HAMILTON, JUDGE
United States District Court
Southern District of Indiana

Copies to:

Donna R. Eide
United States Attorney's Office
10 West Market Street, Suite 2100
Indianapolis, IN 46204-3048

Larry A. Mackey
Barnes & Thornburg
11 South Meridian Street
Suite 1313
Indianapolis, IN 46204-3556

Fred Scott
Attorney at Law
55 Monument Circle, Suite 814
Indianapolis, IN 46204

Mark D. Stuaan
Barnes & Thornburg
11 South Meridian Street, Suite 1313
Indianapolis, IN 46204